Mr Noyer sheds some light on the international role of the euro

Speech presented by Mr Christian Noyer, Vice-President of the European Central Bank, before the Monetary Commission of the European League for Economic Cooperation, held in Kronberg, on 26 November 1999.

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Introduction

First of all, I should like to thank the Monetary Commission of the European League for Economic Cooperation for inviting me to address such a distinguished audience and to shed some light on trends, advantages and risks, or rather challenges, with respect to the international role of the euro.

Economic and Monetary Union (EMU) marks a historic step in the European integration process as sovereign states have replaced their national currencies with a common currency and transferred their monetary policy competencies to a newly established supranational institution. European integration, in the monetary sphere as well as in a number of other fields, is a process that has been under way for several decades now and will continue well into the future.

EMU and the single monetary policy in the euro area are completing the single market for goods, services, people and capital in Europe, with a view to enhancing the welfare of citizens within the European Union. Moreover, the introduction of the euro and its prospectively increasing international role are likely to have far-reaching consequences for the world economy and the international monetary system. Against this background, the ECB shares with other policymakers in Europe a particular responsibility in setting the right conditions for sustainable and non-inflationary growth in the euro area so as to contribute to the long-term economic welfare of the world economy.

Today, I shall first concentrate on a few trends of the euro as an international currency, even though available statistical evidence only allows preliminary conclusions. Then, I shall discuss the main factors that may influence the international dimension of the euro in the future. Finally, I will turn to the consequences, in terms of advantages and possible challenges, that a greater use of the euro by international agents might bring about, both for the euro area itself and in the international context. As a general remark, it must be emphasised that the Eurosystem is taking a neutral stance regarding the international role of its currency. This means that we neither hinder nor actively promote the international use of the euro, leaving future developments to be determined primarily by market forces.

1. The euro as an international currency

By definition, a currency acquires an international dimension to the extent that private economic agents and official institutions use it outside its own jurisdiction. As in the domestic framework, in the international context economic agents need an instrument which fulfils the three basic functions of money, namely that of a unit of account, a medium of exchange and a store of value. Therefore, a currency can be characterised as international if it is used, first, for pricing goods and services in international trade and commodity markets; second, as a vehicle for commercial and financial transactions in the trading of goods or of currencies in the foreign exchange markets; and third, as a store of value for investment and financing purposes. There are even extreme cases, for example hyperinflation, where domestic economic agents may completely lose confidence in the currency issued in the jurisdiction in which they operate and resort instead to an international currency to perform the internal functions of money.

Along the same lines, an international currency can be used as a reference in the official sector for pegging the domestic currency, as a tool for foreign exchange intervention purposes and as an instrument for holding official reserves.

Even though all of the uses I have just mentioned are in part interdependent, this does not necessarily imply that the internationalisation of the euro will proceed at the same pace in all its different functions. Two main conditions are necessary for a currency to acquire international status: low risk and large size. While the euro has the potential to meet these two conditions, network externalities and economies of scale tend to create inertia underpinning the current predominance of the US dollar. These effects, linked to the size factor, are greater for the unit of account and the medium of exchange functions of money than for its function as a store of value. Instead, for this function, the risk factor actually encourages diversification and therefore provides scope for the euro to grow more rapidly as an international currency.

On the basis of available information, it has turned out that the euro is today the second most widely used currency internationally, after the US dollar and ahead of the Japanese yen. This is in part a reflection of the significant international role already played in the past by some of the euro's legacy currencies, primarily the Deutsche Mark. It is also related to the economic and financial weight of the euro area in the world economy. Euro area GDP amounts to almost EUR5,800 billion, representing over 15% of world GDP once differences in price levels across countries are taken into account. The United States, with a GDP of EUR7,600 billion, account for close to 21% of the world GDP. The GDP of Japan, the third largest economy in the world, is much smaller, at EUR3,400 billion and a share of 7% in world GDP. The size of financial markets reflects the same relative positions, even though – in this case – the fact must be borne in mind that the structure of the financial system of the euro area differs from that in the United States. Thus, the stock market capitalisation of the euro area amounted to 63% of GDP at the end of 1998, far below the level prevailing in the United States at 155% of GDP. On the other hand, the higher level of domestic credit, 130% of GDP in the euro area, compared with 81% of GDP in the United States, indicates that bank financing is more important in the former economic area than in the latter.

Until now, international market participants seem to have received the euro quite well after its launch at the beginning of this year, even though it might be too early to come to a meaningful assessment. In particular, it is difficult to judge the extent to which one-off factors, such as the postponement of issues after the launch of the euro or the desire to establish benchmark status, contributed to the strong rise of the euro in international bond financing.

However, in the first three quarters of this year, the share of euro-denominated announced issues of international debt securities and money market instruments has been consistently higher than that of the euro's legacy currencies in the same period of 1998, as these shares amounted to 36% and 24%, respectively.

The shares of the three key currencies in terms of amounts outstanding are relatively less affected by recent developments even though the nature of this indicator is less forward-looking. At the end of September 1999, 46% of all outstanding international short and long-term securities were denominated in US dollar, 29% in euro and 10% in yen.

Data for international banking statistics are consistent with this ranking. At the end of June this year, cross-border bank lending extended by reporting banks from industrialised countries was denominated as follows: 42% in US dollar, 35% in euro and 10% in yen. These figures, however, are not net of intra-euro area positions that can no longer be regarded as cross-border transactions.

In the foreign exchange markets, the last comprehensive survey on turnovers was carried out by the Bank for International Settlements (BIS) in the spring of 1998, i.e. before the introduction of the euro. Available information seems to indicate that, in line with a contraction of foreign exchange market turnover, trading volumes in euro against the US dollar are lower than former activity involving the euro's legacy currencies.

Only very limited evidence is available on the use of the euro for international commodity pricing and trade invoicing. In the past, the euro's legacy currencies were not as widely used in trade invoicing as the US dollar. In 1992, 28% of world trade was invoiced in the main euro area currencies, compared with 48% in US dollar, which was a much larger share than that of the United States' exports in international trade, which amounted to only 16% last year. The US dollar is also predominant in use as a quotation currency and inertia effects will contribute to maintaining its status in the future. However, the size of the euro area financial market and the weight of the euro area in international trade flows, given that 20% of all world exports originated in the euro area in 1998, may bring about over time a greater weight of the European currency in trade invoicing patterns.

Turning to the official sector, two pieces of information are worth mentioning.

The first is related to the use of the euro as a reference currency in pegging arrangements or in the management of the exchange rate by non-euro area countries. Apart from the exchange rate mechanism ERM II, in which Denmark and Greece currently participate, a substantial number of countries outside the EU have unilaterally adopted the euro, or one of its legacy currencies, as a reference currency in a formal or informal way. Some countries, such as Bosnia-Herzegovina, Bulgaria and Estonia, have established currency boards. Others maintain pegging arrangements to the euro – as in the case of Cyprus, the Republic of Macedonia and as many as 16 African states, most of which belonging to the CFA zone – or to currency baskets in which the euro plays a predominant role, as in the case of Hungary, Iceland, Poland and Turkey. Some countries, such as the Czech Republic, the Slovak Republic, Slovenia and Romania, have informally linked the exchange rates of their currencies to the euro.

In addition to its role as a reference currency, the euro is held for reserve management purposes by monetary authorities outside the euro area. The latest available data published by the IMF in its annual report provide an indication of the share of the euro in worldwide official reserves at the end of 1998, just before its formal introduction. At that time, of the total worldwide official reserves for which a currency breakdown is available (SDR928 billion), 17% were held in the euro legacy currencies, compared with a share of 71% for the US dollar and 6% for the yen.

2. Factors affecting the future international role of the euro

The international role of the euro is likely to evolve gradually in the future. Even the US dollar required a very lengthy process to gain its present status, which took several decades and was fully completed only in the 1950s. Growing importance of the euro as an international currency could develop differently as EMU represents a one-off regime shift and as the emergence of a global financial market could speed up the internationalisation of the euro.

A first prerequisite for a significant use of the euro by foreign agents is confidence in the stability of its purchasing power in the long run. This is the primary objective of the Eurosystem. In this respect, the value of the euro is based on domestic price stability and on the medium-term orientation of the Eurosystem's monetary policy.

Other factors will also play a role.

One important aspect is the possible future enlargement of the euro area. Four EU countries have, for different reasons, not yet adopted the euro. Without elaborating on that, let me simply state that I am confident that they may join in the coming years. If and when this happens, the economic and financial size of the euro area would be further enhanced, providing new impetus to the international role of the euro.

A greater challenge is the potential accession of new countries to the European Union. Negotiations are currently being conducted with six countries. Negotiations with another six candidates will start soon. When joining the EU, the new Member States will have to comply with all the requirements set out in the *acquis communautaire* which relate to Economic and Monetary Union (EMU). Therefore, following their accession to the EU, the new Member States will also – in a second step – become members of ERM II and will – in a third step, if and when the Maastricht convergence criteria are met – adopt the euro. The accession process entails that, over time, the exchange rate and monetary policies of candidate countries will become increasingly focused on the euro with implications for its international use.

A second factor relates to the euro area financial market. The acceptance and use of the euro by foreign agents are to a large extent determined by the efficiency and integration of the euro area money and capital markets. In this connection, progress has been made, especially with regard to those sectors of the financial system which are used as the primary channels for the operation and transmission of the single monetary policy. Thus, thanks to the TARGET system, money markets are now close to perfect integration, given that the spreads amongst euro area countries are extremely low and reflect different credit standings of counterparties rather than market segmentation.

In clearing, settlement and trading systems for securities, integration is not quite as complete as in money markets, but a process is under way to create a euro area-wide financial infrastructure by linking existing national systems. In government bond markets, segmentation may not be eliminated completely since, as you know, each Member State remains responsible for its own fiscal and public debt management policy. Therefore, public bonds in the euro area will continue to be characterised by yield spreads which reflect mainly the differences in the credit standing of sovereign national issuers and in market liquidity conditions.

However, the ongoing integration of financial markets in the euro area as well as increasing competition amongst intermediaries are likely to bring about greater liquidity, lower transaction costs and the development of a wider array of financial products. As this process develops, the international use of the euro is likely also to benefit from it.

I would like to mention a last aspect of the internationalisation process of the euro. This refers to the possibility that the large size of the euro area as well as its lower trade openness, as compared with the participating Member States, might contribute to reducing the vulnerability of its economy and financial markets to possible external shocks, making euro area developments less correlated with trends prevailing abroad. Against this background, euro-denominated assets would provide international investors with an opportunity to diversify their portfolios, enhancing the risk-return profile thanks to the pooling of not closely correlated assets.

The development of the euro as an international currency is not likely to be a steady process. The possible increase in the international use of the euro may not be rapid in early years until a critical threshold is reached attracting more and more international agents. Besides, the euro is probably going to develop faster as an international store of value than as an international transaction and pricing instrument. Furthermore, the reaction of different international investors to the introduction of a new currency might develop at different paces. In particular, this might hold true of private vis-à-vis official investors: the former are usually inclined to pursue more dynamic investment strategies than is customary for central banks, whose investment behaviour is more conservative. Therefore, the evolution of the euro as an official reserve currency is not likely to be as rapid as its use by the private sector, where data on international debt security issues indicate a swift increase in the use of the euro as an investment and financing currency.

Let me now briefly turn to the possible impact that the internationalisation of the euro might have in areas of relevance to the Eurosystem.

3. Advantages and challenges of the international role of the euro

A greater international use of the euro both has advantages and poses possible challenges.

Concerning the positive repercussions for the euro area economy and financial markets, I should only mention that an increased use of the euro by international market participants is bound to add breadth and efficiency to the euro area financial markets. Higher trading volumes imply increased liquidity, which helps to enhance the efficiency of the market in terms of both lower transaction costs and asset price developments which are better aligned with fundamentals and new information.

However, more than a source of favourable developments, I take the internationalisation of the euro primarily as an *ex-post* sign of the progress made in creating a large and well-functioning financial market. As a matter of fact, international agents will increasingly resort to the euro only if the supporting financial infrastructure and capital markets are sufficiently integrated and efficient so as to provide easy and beneficial access to non-resident as well as to domestic market participants.

On the other hand, there are also challenges linked to an internationalisation of the euro, which have to be given due attention.

First of all, euro assets could increasingly become affected by short-term portfolio shifts on the part of international investors bringing about volatility and swings in corresponding asset prices. This does not need to have negative implications for the euro area. For example, capital inflows linked to the role of the euro as a "safe haven" currency may help sustain asset prices of bonds and equities. However, even such flows of funds can pose risks if their effect goes as far as distorting asset prices. In general, a swift withdrawal of funds by international investors might have an impact on the financial sector if this is subject to a sudden and substantial drain of resources, especially for those institutions with possibly mismatched positions.

The internationalisation of the euro may also pose challenges to the Eurosystem's monetary policy. A greater external use of the euro might affect the information content of both monetary aggregates and other indicators, which are parts of the so-called second pillar of the Eurosystem's monetary policy strategy. Concerning the first point, the increase in demand for euro banknotes, at present only in the form of its national denominations, would make the M1 component of M3 more volatile and less meaningful for monetary policy purposes. Other components of M3 could also be affected if residents move funds held with domestic Monetary Financial Institutions (MFIs) abroad or vice-versa, or if part of the money market instruments included in M3 come to be held by non-residents. Instead, deposits held with MFIs by non-residents are not computed as part of M3, and thus their trend does not affect money growth even though it might alter the relationship between M3 and money demand or the price level. Among the indicators included in the second pillar, the exchange rate is the indicator most susceptible to be influenced, even though the international use of the euro might also have an impact on the yield curve and make the conduct of macroeconomic forecasting more complex.

Overall, it seems that none of the aforementioned factors will seriously endanger the ability of the Eurosystem to conduct a monetary policy geared to price stability. However, they impose on the Eurosystem a greater analytical challenge in examining current developments and a need for the availability of accurate and up-to-date information in the areas concerned. To the extent that the international role of the euro contributes to capital market efficiency in the euro area, the operation and transmission of monetary policy might even be enhanced.

For the international monetary system, the introduction of the euro certainly represents one of the most profound changes since the collapse of the Bretton Woods system in the early-1970s. In the first place, Western Europe has ceased to be the area of currency instability that it has been at times in the past and the Eurosystem's commitment to price stability will contribute to the stability orientation of the euro area. As regards the process of international cooperation, the emergence of a key player with the responsibility and the ability to take a more consistent stance at the global level than was previously the case is bound to simplify the exchange of views and information at an international level, fostering – whenever possible – the adoption of common initiatives. By reducing the number of key players and by strengthening the awareness of each player to take up their respective responsibilities, the euro will – over time – contribute to facilitating the process of international cooperation.

Conclusions

The euro acquired the status of an international currency from the time of its introduction as a result both of the characteristics of some of its legacy currencies and of the large size of the euro area economy and financial markets.

How and to what extent the international use of the euro will evolve in the future remains rather more open. An increasing international role of the euro in the years to come can certainly be expected, even though such a process will take time and will not affect the main international uses of the euro to the same extent.

The internationalisation of the euro will to a large extent depend on the creation of a large, unified and efficient capital market in the euro area. Its possible challenges appear to be manageable, in particular those with regard to the Eurosystem's monetary policy.

From an international perspective, the euro as a stable currency opens up new opportunities for international agents, and maintaining price stability in the euro area is also the best contribution the Eurosystem can make to global stability.